

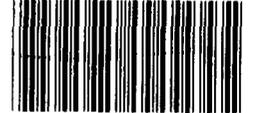
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STATEMENT OF

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BEFORE THE

HOUSE COMMITTEE ON POST OFFICE AND CIVIL SERVICE

SUBCOMMITTEE ON COMPENSATION AND EMPLOYEE BENEFITS

ON

PROPOSED CHANGES TO THE MERIT PAY SYSTEM AS DESCRIBED

IN THE "CIVIL SERVICE AMENDMENTS OF 1984" (H.R. 5066)

AND "THE MERIT PAY IMPROVEMENT ACT" (H.R. 5401)

Madam Chair and Members of the Subcommittee:

We are pleased to be here to discuss the proposed merit pay bills. We have issued three reports on the merit pay system and believe that it needs to be changed. We concur with the objectives of both bills, and believe that either could improve the current system. I would like to begin by describing the bills' main provisions. Both bills would:

--Eliminate the merit pay "pool" concept. A merit pay pool is an organizational subunit composed of employees covered by an agency's merit pay system. Employees in a pool compete against each other for merit pay increases. In our most recent merit pay report, we noted the amount

of money employees received in the three agencies we reviewed was not only determined by their performance appraisal, as required by law, but it was also influenced by a variety of nonperformance factors related to the merit pay pool, such as the grades and salaries of pool members and the way ratings are distributed within the pool. Removing the merit pay pool should help (1) reduce the effects that these nonperformance factors have on employees' merit increases and (2) ease the negative perceptions many employees have about the fairness of the merit pay system.

- Require that merit pay employees receive uniform amounts for step increases for specific performance levels. This change should also reduce the negative perceptions employees have about the fairness of merit pay. These perceptions stem from the vast differences in individual merit pay increases awarded throughout different pools.
- Guarantee the full annual General Schedule salary increases to all employees rated at least fully successful. The bills also state that each employee rated outstanding will receive a full step increase (about 3 percent of the minimum rate for the grade).
- Require that agencies pay a performance award to all employees rated in the top performance category. The two bills also require agencies to allocate a specified

amount of money each fiscal year for performance awards which represents an increase in emphasis on performance awards.

--Require that the performance appraisal systems establish critical elements and job-related performance standards which permit accurate evaluation of job performance. The bills also require that supervisors at least communicate these elements and standards to employees at the beginning of the appraisal period.

--Prohibit the Office of Personnel Management (OPM) and the agencies from prescribing the distribution of levels of performance ratings.

We support the reinforcement that both bills place on the pay-for-performance concept. Both bills contain provisions to (1) connect the timing and the amount of "step increases" to employees' performance ratings and (2) deny or restrict the amount of annual salary adjustments for less than fully successful performers. These provisions are consistent with the Civil Service Reform Act's (CSRA's) intent to make pay increases more contingent upon performance.

Both bills will require OPM to submit an annual report to the President and each House of Congress evaluating the effectiveness of the proposed performance management and recognition system. The CSRA imposes a similar requirement on OPM to analyze the cost and effectiveness of the merit pay system and cash award program and to publish the results annually. However, as

we noted in our recent merit pay report, OPM has not fully complied with this requirement. We believe OPM should provide the Congress with a meaningful analysis of the new program's effectiveness to help it decide whether to extend this program beyond the experimental stage.

Finally, both bills are experimental and most of their provisions would terminate after about 5 years. GAO has previously pointed out that performance appraisal and merit pay systems should be thoroughly tested and evaluated. Furthermore, compensation experts have said that it can take from 5 to 10 years before these systems operate as intended.

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I would now like to provide additional details on these provisions and some other observations on the two bills. Most of the information we will provide is based on our recent report to this Subcommittee entitled: A 2-Year Appraisal of Merit Pay in Three Agencies (GAO/GGD-84-1, March 26, 1984).

ELIMINATION OF THE MERIT
PAY POOL CONCEPT

Under the current merit pay system, certain employees are placed in merit pay pools and compete against each other for merit pay increases. The merit pay fund is a fixed amount made up of a maximum of one-half the annual General Schedule salary adjustment plus an amount equal to the within-grade and quality-step increases that would have been paid to members of the pool had they remained under the General Schedule. Within

the pool, if one employee is rated high and receives a large increase, it is at the expense of another, since the total pool fund available to pay the increases is fixed. Eliminating the pool concept will address the "winners versus losers" stigma attached to merit pay.

Eliminating the pool concept also addresses another concern. This concern is that employees' merit pay increases can be dependent upon, not only the appraisal, but also certain non-performance factors--the grades and salaries of the pool members, the pool size, and the distribution of ratings within the pool.

The combination of employees' grades and positions in the salary range affects the amount of money included in, and can thereby influence the individual merit pay increases made from, the merit pay pool fund. OPM's merit pay formula requires that different amounts be included in the pool fund for grade 13's, 14's, and 15's at different positions in the salary range. Therefore, the total fund amount can vary depending on the number and combination of grades and salaries in the pool.

The number of employees in a pool is also a factor that can affect merit increases. In small pools containing 10 or fewer people, for example, the effects of rating differences are accentuated. In effect, one individual's performance can affect another's merit pay increase more than if both employees were in larger pools. In large pools, on the other hand, ratings and,

therefore, pay, may not be consistent. This is because some supervisors rate harder than others. As a result, pool members with lenient supervisors may benefit at the expense of their co-workers in the same pool whose raters are stricter. Of course, the problem of easy versus hard raters would exist under any type of performance appraisal system, but can be even more critical when pay is involved.

The way ratings are distributed within a merit pay pool is also crucial in determining the merit pay increase each employee receives. As a result, employees in pools with very different ratings distributions can receive significantly different amounts of money, even if they have received a comparable rating. In addition, when many people within the pool are highly rated, top performers will receive less money than if most were rated at a lower level. This is true even in pools which have the same number of employees and the same amount of money.

Our study at three large agencies--the Departments of Agriculture, Housing and Urban Development (HUD), and Navy--identified differences in merit pay systems caused by factors unrelated to performance. For instance, in HUD in 1981, employees rated at the second highest level in one pool received average merit increases almost twice as large as employees rated at the highest level in another HUD pool.

MORE UNIFORM USE OF
PERIODIC STEP INCREASES

Both bills would require payment of a uniform amount of money for step increases at specific grades and performance levels. All employees in the lower third of the salary range rated fully successful or better would receive step increases equivalent to those received by General Schedule employees. Employees in the rest of the salary range would receive step increases at different rates based on their performance. For example, each year that employees receive outstanding (highest) ratings, they will earn the equivalent of a step increase (about 3 percent of the minimum rate for the grade). Employees in the second highest rating category would earn 50 percent of the equivalent of a step increase and employees rated fully successful would earn one-third of an equivalent step increase.

Some of the differences in merit pay increases among agencies can be attributed to the different formulas agencies use for computing merit pay increases. Formulas can include variables such as a performance salary ceiling--limiting the salary within each grade according to the level of performance. Formulas can also include acceleration factors which award larger increases to employees lower in the salary range. In addition, agencies can use different values for the points or percentages assigned to performance levels, and the number of performance levels can vary. Because of the many possible variations, merit pay can be very different for similar ratings.

The two bills would eliminate the factors that cause variations and thus simplify the system.

RESTORATION OF FULL ANNUAL
GENERAL SCHEDULE INCREASES

One of the main concerns of employees covered by the merit pay system has been that they were not guaranteed the same annual salary increases that most General Schedule employees receive. This has concerned merit pay employees who must compete with their peers for merit pay increases. Both bills would guarantee the full annual General Schedule increases to employees rated fully successful or higher.

PAYMENT OF PERFORMANCE AWARDS

Both bills would increase emphasis on and specify minimum funding levels for performance awards. Our three-agency review showed a large difference in the number and average amounts of performance or cash awards paid to merit employees in the three agencies. For instance, in 1981, one agency gave 15 percent of its merit employees awards averaging about \$2,700. In 1982, the same agency gave awards averaging \$1,100 to 31 percent of its merit employees. This agency's merit pay employees generally seemed to be more satisfied with merit pay than their counterparts in the other two agencies we reviewed. At these two agencies, only about 6 percent of the employees in both years received bonuses averaging \$500 in one agency and \$1,000 in the other.

Some of the positive aspects of these performance awards are that they (1) would be immediately available to be spent; (2) would reward the performance of that particular year; (3) could be accompanied by publicity and peer recognition; and (4) should be relatively easy to process. The performance awards as described in both bills would allow management the flexibility to give employees rated at the top 2 performance levels up to 20 percent of base salary.

COMMUNICATION OF ELEMENTS AND
STANDARDS AT THE START
OF APPRAISAL PERIOD

Both bills require that supervisors at least communicate to employees the critical elements and performance standards on which they will be judged at the beginning of the appraisal period. This is consistent with the CSRA requirement that the performance standards and critical elements of the employee's position be communicated to each employee at the beginning of the appraisal period. In our review, we found that at one agency over 40 percent of merit pay employees with signed and dated standards had not received their standards until 6 months or more into the fiscal year 1982 appraisal period. We believe that it is important that standards and elements be communicated at the beginning of the appraisal period to clearly inform employees what is expected of them and the criteria upon which their final ratings will be based. Early communication of standards can also reduce the likelihood that an employee will disagree with the final rating.

PROHIBITION OF PRESCRIBED RATING DISTRIBUTIONS

The two bills specifically prohibit OPM and the agencies from prescribing the distribution of levels of performance ratings. OPM regulations already prohibit forcing rating distributions to fit quotas. However, our work showed that the use of quotas in developing ratings was a perceived problem among employees. Our survey of the 1982 merit payouts at the three agencies showed that between 30 and 59 percent of the employees thought management used quotas for ratings.

Our review also showed that employees who believed quotas were used generally had a more negative attitude toward merit pay. We believe that the prohibition described in the bills should help curb forced rating distributions and is a positive aspect of the bills.

EXPERIMENTAL NATURE OF THE TWO BILLS

As we have previously noted, compensation experts have stated that it might take from 5 to 10 years for a compensation system to operate as intended. Most provisions in these two bills will terminate after about 5 years. By that time the performance appraisal systems used for merit pay will have been in effect for at least 8 years. This 8-year period should allow the Congress enough time to determine the effectiveness of merit pay. Thus, the 5-year life of this proposed system, with a re-assessment of the entire system at that time, appears reasonable.

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A major difference between H.R. 5401 and H.R. 5066 is the minimum funding level provided for performance awards. H.R. 5066 would require a minimum funding level of three-fourths of 1 percent of the total amount of basic pay for merit pay employees. Also, H.R. 5066 would encourage agencies to increase this amount every year so that by the fourth fiscal year after enactment, the total amount for performance awards would represent at least 1.5 percent of total payroll for merit pay employees. H.R. 5401 would require a minimum funding level of 1.5 percent of total payroll the first year with specified increases in subsequent years. H.R. 5401 also requires that a performance award for top-rated performers shall not be less than 3 percent nor more than 20 percent of an employee's base salary. H.R. 5066 requires only that performance awards be no more than 20 percent of base salary.

H.R. 5401 also requires agencies to establish boards to review performance standards before they are implemented and to certify the suitability of the standards. This should better ensure that performance standards contain, to the extent feasible, the desired characteristics of objectivity and measurability, and that the performance standards are of comparable difficulty for similar jobs.

In summary, it appears that both bills, H.R. 5401 and H.R. 5066, would address some of the major concerns that employees

have with the present merit pay system and should eliminate the perceived inequities that employees believe exist between merit pay and the General Schedule. Both bills would still provide an incentive for better performance through performance awards and performance-based, within-grade advancement schedules. The performance awards system of each bill would permit highly rated employees to earn amounts greater than under the General Schedule system. And, the proposed within-grade adjustment schedules would enable top-rated performers to move more quickly to the top of their pay range.

This concludes my testimony, Madam Chair. We will be happy to answer any questions you may have for us.